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NO. 537.

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1934.

GUY T. HELVERING, Commissioner of Internal Revenue,
Petitioner,

vs.

INTER-MOUNTAIN LIFE INSURANCE COMPANY,
Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE TENTH CIRCUIT

MOTION FOR LEAVE TO FILE BRIEF AS AMICI CURIAE AND BRIEF

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PRESS OF BYRON S. ADAMS, WASHINGTON, D. C.

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MOTION FOR LEAVE TO FILE BRIEF AS AMICI CURIAE

May it Please the Court:

The undersigned respectfully move this Honorable Court for leave to file the accompanying brief in this case as *amici curiae.*

HOMER HENDRICKS,
GEORGE M. WOLCOTT,
O. H. CHMILLON,
Amici Curiae.

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BRIEF AMICI CURIAE.

PRELIMINARY STATEMENT.

The undersigned are counsel for the taxpayers in the following cases: *Southern Union L. Ins. Co. v. Commissioner*, Docket Nos. 59328 and 64351, now pending before the

United States Board of Tax Appeals;[1] *Commissioner v. A. B. Chandler and Fidelity & Columbia Trust Co., Receivers, Inter-Southern L. Ins. Co.*, on appeal by the Commissioner to the United States Circuit Court of Appeals for the Sixth Circuit; and *Commissioner v. Montana L. Ins. Co.*, on appeal by the Commissioner to the United States Circuit Court of Appeals for the Ninth Circuit. In each of these cases, there is involved the question whether the taxpayers are entitled to deduct from gross income, four per cent of the mean of reserves maintained in respect of matured, unsurrendered coupons attached to life insurance policies of the type involved in the case now before this Court. The taxpayers represented by the undersigned have taken the position that they are entitled to such deductions.

QUESTION PRESENTED.

Whether reserves required by state law to be maintained on account of portions of the valuation of coupon life insurance policies represented by such coupons are "reserve funds required by law", within the meaning of Sec. 245 (a)(2) of the Revenue Act of 1921.

STATUTES.

Sec. 245(a)(2), Revenue Act of 1921, 42 Stat. 227, 261, provides that in the case of a life-insurance company the term "net income" means the gross income less—

> "(2) An amount equal to the excess, if any, over the deduction specified in paragraph (1) of this subdivision, of 4 per centum of the mean of the reserve funds required by law and held at the beginning and end of the taxable year, plus (in case of life-insurance companies issuing policies covering life, health, and accident insurance combined in one policy issued on the weekly premium payment plan, continuing for

[1] In these cases, the Board on Jan. 10, 1935, entered an order vacating and setting aside judgments previously entered for the taxpayer, pending the decision of this Court in the Inter-Mountain Case.

life and not subject to cancellation) 4 per centum of the mean of such reserve funds (not required by law) held at the beginning and end of the taxable year, as the Commissioner finds to be necessary for the protection of the holders of such policies only."

SUMMARY OF ARGUMENT.

The coupon reserves were maintained to meet insurance obligations. They performed the same fundamental funtion as other true insurance reserves.

Precisely the same reason exists for allowing the deduction of four per cent of the mean of the coupon reserves as exists for allowing the same deduction in respect of other true insurance reserves. The amounts reserved in respect of the liability on the coupons represented a part of the gross premium paid by the insured, with interest accretions, the same as reserves in respect of other obligations of the policy.

The rule of allowing the deduction as interest paid, followed by the Bureau of Internal Revenue, results in a distortion of the annual net income. Under this method, the amount of deductible interest in any one year will depend on vicissitudes, such as the need of holders of coupon policies for funds (causing them to cash the amount of matured coupons and accumulated interest),—having no relation whatever to the fact that out of the "interest, dividends, and rents" received by the company in any year a certain proportion must be reserved for the purpose of carrying out its coupon policy contracts as a whole. On the other hand, by allowing four per cent of the mean of the reserves in any year, the net income is accurately computed, for the deduction from gross income is increased or decreased according to the requirements of the company to accumulate interest for the purpose of meeting the policy obligations.

The question involved in this case is not controlled by the decisions of this Court in the cases cited in the Commis-

sioner's brief. On the other hand, the opinion in *Williams v. Union Central L. Ins. Co.*, 291 U. S. 170, inferentially at least is in support of the proposition that the coupon reserves are true insurance reserves and thus "reserves required by law" within the meaning of the Federal income tax acts.

ARGUMENT.

1. The Coupon Reserves Were Maintained to Meet Insurance Obligations. They Performed the Same Fundamental Function as Other True Insurance Reserves.

It appears that the following propositions cannot be disputed:

(1) The coupons attached to the policies involved in this case were integral parts of the policy contract.

(2) The amounts which the insurance company reserved in respect of its liability on the coupons represented a part of the gross premiums paid by the insured, with interest accretions, the same as reserves in respect of other obligations of the policy.

(3) Higher premiums are charged for policies having the coupon feature than are charged for policies without coupons and the company issuing coupon policies must provide for its obligations under the coupon feature out of these premiums.

(4) The obligations of the insurance company in respect of the coupon feature of the policies were as much a part of the policy contract as were obligations to pay death claims as they arose, and it was as necessary to maintain reserves for one obligation as for the other.

The Commissioner's error lies, first, in his attempt to separate the coupon obligations from the other obligations of the policy, and second, in his refusal to recognize that the reserves maintained in respect of the coupons (whether they

are regarded as "accrued" or as "contingent" liabilities) performed the same fundamental function and are entitled to the same income tax treatment as other true insurance reserves.

Under the Commissioner's theory, it was as if the insured and the company had entered into two separate contracts—one which dealt with straight life insurance and another, a contract of mere deposit, which permitted the insured to make a loan to the company of a part of the sums which are described in the policy as premiums. The error of this theory was pointed out in the opinion of the Circuit Court of Appeals for the Third Circuit in the case of *Commissioner v. Standard L. Ins. Co.*, 47 F. (2d) 218, 219. In that case, Judge Buffington described the coupon policies of the Standard Life Insurance Company, which were similar in all essential respects to the policies here in question, as follows:

> "These coupon policies are in substance and in obligation the common form of life policies made more attractive to intended insurers, in that the substitution of a coupon for the ordinary yearly statement of accretions to the policy, whether the company chose to issue a coupon or gave a statement of amount, in no way lessened the obligation to ultimately and in some way pay such amount as part of the policy or keep in reserve a proper sum to insure its payment."

The opinion of those best qualified to reach an opinion, the National Convention of Insurance Commissioners, announced in a resolution adopted at their convention held in 1927, is that the amounts in question from the insurance standpoint are "reserves required by law." The resolution, quoted by the Board of Tax Appeals in *Standard L. Ins. Co.*, 13 B. T. A. 13, 26, stated:

> "* * * The proceeds of such matured coupons are, clearly, held by such companies to meet guaranteed policy obligations at maturity. They are therefore reserves required by law and should be included in the

reserves of the company reported above Line Seven on the Convention blank."

The reserve in respect of policies of this type is in reality a composite reserve, made up, first, of the reserve in respect of the twenty-year payment life features, and, second, of the reserve in respect of the coupon features. Either element in the composite reserve would not alone be sufficient to cover the obligation of the whole policy. Without the reserve in respect of coupons, the other portion of the reserve would be too low.

2. Precisely the Same Reason Exists for Allowing the Deduction of Four Per Cent of the Mean of the Coupon Reserves as Exists for Allowing the Same Deduction in Respect of Other True Insurance Reserves.

The reason for allowing the deduction in the case of life insurance policies not having coupon features is clear. Out of the total premium received, a certain portion must be reserved by the company, and interest accumulated thereon at a rate specified by the laws of the states, in order to enable the company to meet its obligations on the policy. Since the interest element in the reserve must be accumulated from "interest, dividends, and rents" (taxable gross income to life insurance companies under the revenue acts in question),[2] that portion of the gross income belongs to the policyholders, and from the standpoint of the company represents a cost of doing business and a proper deduction from gross income if it is to be taxed on its true annual income.[3]

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[2] Rev. Acts of 1921, 1924, and 1926, Sec. 244(a), Rev. Acts of 1928, 1932, and 1934, Sec. 202(a).

[3] In *National L. Ins. Co. v. United States*, 277 U. S. 508, 525, Mr. Justice Brandeis (dissenting) said in reference to the statutory provisions in question, "The reason for allowing the deduction of 4 per cent of the reserve is that a portion of the 'interest, dividends, and rents' received has to be used each year in maintaining the reserve, i. e., adding to it on the basis of a certain interest rate, varying from 3 per cent to 4 per cent according to the requirements of the statutes of the several states."

When the coupon features are added to the policy, precisely the same reason exists for allowing the deduction of the mean of the additional reserves required on account of the coupons. A certain part of the premium must be set aside and reserved for the policyholders.[4] Interest must be added to this amount annually, in order for the company to be able to meet its obligation under the policy. This interest must be accumulated from the "interest, dividends, and rents" of the company, in precisely the same manner as in the case of other reserves built up from premium payments with interest accretions thereto.

The deduction of four per cent of the mean of the "reserve required by law" was put in the Federal income tax acts in recognition of the fact that the life insurance business is conducted on the basis that policy obligations will be liquidated out of premiums, invested at an assumed rate of compound interest.[5] Thus, aside from administrative costs and the academic possibility of beating the mortality tables, an insurance company must earn the assumed rate of interest on its investment (aside from investments of original capital and surplus) to come out even. The four per cent of its reserves represents the cost of their maintenance. This interest element in the reserve for policies not having coupons is well understood, but it is equally true,

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[4] Since the coupon reserves are reserved from premiums, they are true insurance reserves, and clearly distinguishable from such "solvency" reserves as reserves for dividends (*Minnesota Mutual L. Ins. Co. v. United States*, 66 Ct. Cls. 481, cert. den. 279 U. S. 856) and reserves for unreported death claims and for the payment of annuities to former soliciting agents (*New York L. Ins. Co. v. Edwards*, 271 U. S. 109).

[5] In the instant case, the coupons bore interest at the rate of 3½ per cent, the same rate of interest prescribed by the Revised Statutes of Utah (Tit. 43, Ch. 3, Sec. 12, quoted on p. 46 of the Commissioner's brief) for policy valuations. There is, of course, a hiatus of ½ per cent between the 3½ per cent interest rate prescribed by Utah law and the 4 per cent deduction permitted by the Rev. Act of 1921, Sec. 245(a)(2), here involved. The hiatus is the same in the case of reserves for other features of the policies as for the coupon reserves. This is because Congress in drawing the Act fixed the 4 per cent deduction at the highest rate prescribed by the laws of the several states. Beginning with the Rev. Act of 1932, Sec. 203(a)(2), the taxing act has provided that "in the case of * * * a lower interest assumption rate, the rate of 3¾ per centum shall be substituted for 4 per centum."

although not so well understood, that the company must also earn the same rate on the extra premium charged for the coupon feature. The contract as to these coupons is that the company will accumulate interest from their maturity until they are cashed, or until they are applied to one of the designated options. Thus, if the insured does not surrender the coupons at maturity, he must eventually be paid the interest; and the company must earn the interest on the premium charged for the coupon feature. If the insured elects one of the options, he will get increased benefits for which the company must have a reserve on hand. In any event the company must set up a reserve out of the excess premium paid for the coupon feature, and this reserve must earn the assumed rate of interest to enable the company to meet whichever one of the obligations it may incur.

In *McCoach v. Ins. Co. of No. America*, 244 U. S. 585, 589, this Court stated the purpose of the Act of 1909 in dealing with insurance reserves, as follows:

> "The act of Congress, on the other hand, deals with reserves not particularly in their bearing upon the solvency of the company, but as they aid in determining what part of the gross income ought to be treated as net income for purposes of taxation."

The foregoing statement is equally applicable to the Acts of 1921 and later years. In order to determine the taxable net income of a life insurance company, it is as necessary to allow the deduction of four per cent of the mean of the coupon reserves as it is to allow the deduction in respect of other true reserves.

3. The Rule of Allowing the Deduction as Interest Paid, Followed by the Bureau of Internal Revenue, Results in a Distortion of the Annual Net Income.

The practice of the Bureau of Internal Revenue is to disallow the deduction of four per cent of the mean of the coupon reserves (S. R. 9610, V-2 C. B. p. 189, cited on page

36 of the Commissioner's brief) and to allow a deduction only for interest actually paid during the year. See I. T. 2717, XII-2 C. B. p. 94, which states:

> "It is held that where coupons are left with the company[6] to accumulate at interest, the amount of such interest actually paid out in cash, or amounts applied to shorten the premium-paying period, or to purchase additional insurance, or to pay renewal premiums, which amounts are considered as the equivalent of cash payments, are allowable as deductions in computing the net income of the life insurance company."

The amounts of the deductions for any year under the two methods will vary greatly. For example, in the instant case, the Commissioner allowed only $897.58 as interest paid (R. 10), while four per cent of the mean of the coupon reserves amounted to $5,460.93 (R. 9).

Under the Commissioner's method, the amount of deductible interest in any one year will depend on vicissitudes such as the need of holders of coupon policies for funds (causing them to cash the amount of matured coupons and accumulated interest, or to use them for the payment of renewal premiums), the election on the part of any considerable number of policyholders to purchase additional insurance or to use the matured coupons for shortening the premium-paying period,—all having no relation whatever to the fact that out of the "interest, dividends, and rents" received by the company in any year a certain proportion must be reserved or set aside for the purpose of carrying out its coupon policy contracts as a whole.

That the annual net income of the company will be distorted by the use of the Commissioner's method seems

[6] The use by the Bureau of the words "left with the company" gives a hint as to its misconception of the terms of these policies and the function which the coupon features perform. The unsurrendered, matured coupons in respect of which reserves are necessary, remain attached to the policies, in the hands of the insured; they are not left with the company, and the company does not know what use the insured will make of them under the various options contained in the policy contract.

clear. In one year, the net income will be understated by an excessive allowance for "interest paid"; in another year, such as is here in issue, the net income will be overstated by the allowance of only a nominal amount for "interest paid."

On the other hand, by allowing four per cent of the mean of the reserves in any year, as a deduction from gross income, the net income of the company for any year is accurately computed, for the deduction is increased or decreased according to the requirements of the company under its contracts to accumulate interest for the purpose of meeting the policy obligations.

4. The Question Involved in This Case is Not Controlled by the Decisions of This Court in the Cases Cited in the Commissioner's Brief.

The Commissioner cites and relies on the decisions of this Court in *McCoach v. Ins. Co. of No. America*, 244 U. S. 585, *United States v. Boston Ins. Co.*, 269 U. S. 197, and *New York L. Ins. Co. v. Edwards*, 271 U. S. 109.

These cases arose under the Acts of 1909 and 1913, imposing excise and income taxes. Under these acts insurance companies were required to include premiums in gross income. The compensating deduction was "the net addition, if any, required by law to be made within the year to reserve funds."[7] In the McCoach Case this Court held that in the case of a company writing fire and marine insurance, reserves for unpaid fire and marine losses did not constitute "reserve funds required by law" so as to entitle the company to deduct the net addition thereto. The company was permitted by the law to deduct the net additions to reserves that were set up in anticipation that losses would occur, and had it been permitted to set up a further addition to the reserve when the losses did occur, a dupli-

[7] Corpn. Excise Tax Act (1909) 36 Stat. 11, 113; Rev. Act of 1913, 38 Stat. 114, 176.

cation would have resulted and net income would have been understated.

United States v. Boston Ins. Co. (in effect overruling *Maryland Casualty Co. v. United States*, 251 U. S. 342) involved a claim for a deduction for the net addition to a reserve for unsettled fire and marine losses. This Court denied the claim on the ground that the reserve in question was not a "reserve required by law." Here, again, the company had on hand already a reserve for anticipated losses, and had it been permitted to deduct the net addition to a new reserve reflecting the actual occurrence of the losses, there would have been in part a duplication of the former reserve.

New York L. Ins. Co. v. Edwards involved the claim of a life insurance company for a deduction of the net addition to a reserve for unreported death claims.[8] The taxpayer's claim was denied on the ground that such a reserve did not constitute a "reserve required by law." The taxpayer already had a reserve in anticipation of death claims, and if it had been permitted to set up a further reserve when the death claims actually occurred, a partial duplication would have resulted.

There is no question of duplicate reserves in the instant case. Admittedly no reserve existed for the coupon obligations until the reserve in question was set up.

The opinion of this Court in the New York Life Case states, in reference to the reserve for unreported death claims:

> "• • • The item under consideration represented a liability and not something reserved from premiums to meet policy obligations at maturity.'"[9]

[8] The case also involved a reserve for the payment of annuities to former soliciting agents, which was, of course, clearly a "solvency" reserve.

[9] 271 U. S. 109, 119.

The coupon reserves in the instant case represented something reserved from premiums, and their purpose was to meet policy obligations at maturity.

On the other hand, the opinion of this Court in *Williams v. Union Central L. Ins. Co.*, 291 U. S. 170, inferentially at least is in support of the proposition that the coupon reserves are true insurance reserves and thus "reserves required by law" within the meaning of the Federal income tax acts. In that case this Court had before it the question whether a dividend due an insured was required to be applied by the company to extend a policy which was otherwise in a lapsed status at the time of the insured's death. This Court held that the dividend was not required to be so applied. The decision was in part based on the conclusion that the dividend was not a part of the "surrender value" of the policy which, had it been sufficient for the purpose, the company would have been required to apply to the purchase of extended insurance. Counsel for the beneficiary evidently relied on *Great Southern L. Ins. Co. v. Jones*, 35 F. (2d) 122 (C. C. A., 8th), in which it was held that the Great Southern Company could not forfeit a policy for nonpayment of the premiums where it held uncashed premium reduction coupons of the insured that were sufficient to extend the policy. Mr. Chief Justice Hughes in distinguishing the Great Southern Life Case, said:

> "In Great Southern L. Ins. Co. v. Jones * * * relating to a similar statute of Oklahoma, the policy provided for guaranteed 'premium reduction coupons' which were fixed liabilities requiring a reserve, and were not dividends in the proper sense as in the instant case."[10]

Apparently, it was the view of this Court that the coupon reserves were a part of the cash surrender value of the policy, hence, a part of the general insurance reserve.

Without further comment, we adopt the reasoning of the

[10] 291 U. S. 170, 182.

decisions in the following cases, which we urge upon this Court as high persuasive authority for the Respondent's position: *Commissioner v. Standard L. Ins. Co.*, 47 F. (2d) 218 (C. C. A., 3d), affirming 13 B. T. A. 13; *Commissioner v. Western Union L. Ins. Co.*, 61 F. (2d) 207 (C. C. A., 9th); *Commissioner v. Great American L. Ins. Co.*, 70 F. (2d) 133 (C. C. A., 10th); and the opinion of the lower court in the instant case, 71 F. (2d) 962.

CONCLUSION.

It is respectfully submitted that the decision of the court below is correct and should be affirmed.

Respectfully submitted,

HOMER HENDRICKS,
GEORGE M. WOLCOTT,
O. H. CHMILLON,
Amici Curiae.

February, 1935.